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FRAUDULENT CONVEYANCE LAW AND BANKRUPTCY.

Moore v. Tearney, 62 W. Va. 72, 57 S. E. 263.

It averts irrelevant discussion to *commence* by looking at this case independent of bankruptcy.

A fraudulent conveyance case invokes three separate tribunals which are as distinct as if each had a different judge. First tribunal. To ascertain (a) whether the grantor delivered the clod of dirt with intent to hinder creditors, and (b) whether the grantee had notice of his grantor's intent. Second tribunal. To compel the grantee to bring into court anything and everything he got, and to sell the property. Third tribunal. To distribute the proceeds of sale. And this third tribunal sits as a court of equity. A moment's reflection makes it plain that totally different questions come before each tribunal; for example, investigating whether the grantor had an intent to hinder sheds no light on the question whether a judicial sale was fairly conducted. Hence, the *reasoning,* in the opinions by one of these tribunals, is seldom relevant to any question coming before either of the other two. Again, it is manifest that the second tribunal is not an appellate court to the first, nor is the third an appellate court to either of the other two.

The judge in this third tribunal, has no function except to distribute the proceeds of sale among those, as to whom the conveyance was void, and what this judge most needs is a knowledge of equity decisions respecting the distribution of the proceeds of sale when fraudulently conveyed property is subjected to the debts of the grantor. White *v.* Graves, 7 J. J. March 522, says: "When the chancellor gets hold of a fund he always makes equal distribution unless prevented by liens, priority by diligence, or other controlling circumstances."

STATEMENT OF FACTS.

I. Hurst was worth only $19,000; to-wit, an $8,000 farm and a $6,000 town-house and $5,000 of personalty.

II. Hurst owed his father-in-law, Tearney, $18,000 and Tearney was surety for $14,000, which Hurst owed the state for taxes collected as sheriff. In this situation Tearney purchased the farm and house, paying $14,000 cash, and he took good care that every dollar went immediately and directly to the state to pay the debt for which he was surety.

III. Tearney did not record the deed but permitted Hurst to remain in possession and hold himself out as owner during six years whereby he was able to incur $35,000 of additional debt while insolvent.

IV. All of Hurst's creditors, except Tearney, united as coplaintiffs to file a bill asking that the conveyance be declared void as to their debts.

(It was a suit by the bankrupt's trustee. It will be presently considered that, in legal effect, it was a suit by all creditors uniting as coplaintiffs; viz., a suit by all who could unite as coplaintiffs.)

V. The court adjudged the conveyance "fraudulent and void as to *the rights of plaintiffs,*" and sold the farm and house for $14,000.

VI. The court now comes to distribute the proceeds of sale, and Tearney asks to prorate, as to his $18,000 borrowed money debt, along with Hurst's other creditors.

This paper discusses two totally different questions. They are questions considered in the VIRGINIA LAW REGISTER of November, 1909, and January, 1910 (see Vol. XV, pp. 497, 657). One depends on fraudulent conveyance law, and the other depends on equity precedent when a chancellor comes to distribute a fund.

FIRST question. Was the conveyance held *invalid* as to Tearney's disconnected debt? Unless the conveyance was invalid, as to his debt, he cannot share in the proceeds of sale. SECOND question. If the conveyance was invalid, as to his debt, then can Tearney prorate with creditors whom he misled to credit an insolvent?

Was the conveyance void as to Tearney's $18,000 debt? Horn *v.* Star Foundry Co., 23 W. Va. 522, says, that a conveyance,

however fraudulent, is *always* valid between grantor and grantee. See the cases, Knowlton's Bigelow, pp. 492 and 63.

Many times a grantee stands both as purchaser and creditor. Tearney admits the doctrine[1] that the conveyance is always valid between grantor and grantee, but his proposition is, that, while valid to him *personally,* it was void as to his debt.[2] When subjected to analysis, his theory is that, if the land be sold to pay Hurst's "creditors" then it is sold to pay him as a creditor. But the West Virginia doctrine is, that the land is sold as belonging to Tearney; it is *his* land, subject to Hurst's creditors. Tearney's theory involves the fallacy that a man may sell his own property to pay a debt due to himself. Here, then, is a subtilty too refined for the average intellect.

Diligent research failed to find a case where, when the conveyance was avoided for fraud-in-fact, the grantee-creditor shared in the proceeds of sale.

Suppose that all of Hurst's creditors, except Tearney, had united as co-plaintiffs in a bill, against Tearney, asking that the conveyance be declared void as to the debts which Hurst owed *them;* and suppose the court had declared the conveyance void as to the "rights" of plaintiffs, would any one suggest that the conveyance had been declared void as to a debt Hurst owed Tearney? Recollect, ancient equity gave no relief except to remove the obstruction which prevented the creditor from levying his elegit. See Angell *v.* Draper, 1 Vern., cited by counsel in Tate *v.* Liggat, 2 Leigh 84. Recollect, the land was sold as belonging to Tearney, subject to Hurst's debts. True, the fraudulent conveyance did not extinguish the debt, but can it be that a grantee-creditor may unite as co-plaintiff to sell his own land? Observe, the conveyance is declared void as to the *rights* of plaintiffs. What *rights* would Tearney have had in the ancient equity

1. See difference between "doctrine" and "principle." Crabb's Synonyms.

2. Fraud attaches to the person, not to the debt. Elizabeth put Twyne in jail. If a grantee sells to Innocent and Innocent sells to Guilty, then Guilty can hold as against the grantor's creditors. But, if Innocent sells to the *grantee,* then creditors may seize. See Whittaker *v.* Whittaker, 175 Mo. 1, citing Knowlton's Bigelow 494; Pomeroy, § 754.

court which gave no relief except to remove the obstruction that prevented the creditor from levying his elegit?

CONSTRUCTIVE FRAUD.

There is, in some states, a line of cases based on what is called the doctrine of "constructive" fraud. Hutchinson *v.* First Nat. Bank, 133 Ind. 271, 36 Am. St. 537, 544, says: "In this state there is no such thing as constructive fraud." It seems sufficient to consider that West Virginia has stood rigidly by Garland *v.* Rives, 4 Rand. 282, and hence constructive fraud cases are irrelevant to any matter at Bar, but it instructs to read opinions like Boyd *v.* Dunlap, 1 Johns Chy.: "If the circumstances are suspicious, the court will not set aside the deed in toto but will let it stand for what is justly due." Knowlton's Big. 473, n, calls it, "The doctrine of partial validity." Bump, Ed. 1872, p. 574, citing such cases as Robinson *v.* Stewart, 10 N. Y. —, says: "A fraudulent transfer does not extinguish a debt due the grantee, but, as soon as it is set aside,[3] the debt becomes available, and the grantee is then entitled to share in the fund the same as any other creditor holding the same rank." Such cases do not confuse a Virginia lawyer when he remembers that, with us, the land is sold as the grantee's property, Milwaukee, etc., R. Co. *v.* Soutter, 13 Wall. 517, 20 L. Ed. 543, speaks to this exact point. Again, it is error to avoid the conveyance further that necessary to pay attacking creditors. Core *v.* Cunningham, 27 W. Va. 206. The so-called "constructive fraud" doctrine is irrelevant to any inquiry in this case. It is imperative to keep in mind that this case has nothing to do with personal intent. Garland *v.* Rives, 4 Rand. 282, exonerated Garland, but the Virginia court could not save his just debt.

The conveyance did not "extinguish" the $18,000 debt Hurst owed Tearney, but, could Tearney file a bill, against himself, to have the conveyance declared void as to his debt? If Tearney could not file such a bill, then could he unite as co-plaintiff?

In the Economical Print Co. Case, 110 Fed. Rep. 514, the deed

3. The expression "set aside" is misleading. It is not set aside; the land is subjected to the debts of those whose execution is obstructed.

was valid as to all creditors *except* Riley: in *this* case the deed is *void* as to all creditors *except* Tearney. Suppose it was a gift (In Virginia) and Tearney was the only subsequent creditor?

But Tearney contends that, when the bill is filed by a bankrupt's trustee, then a grantee-creditor has rights which he would not have if the bill had been filed by all the other creditors, united as co-plaintiffs. Observe. This contention stands on two distinct propositions, neither of which will bear analysis. (a) That the Bankrupt Act created *new* rights respecting transactions prior to the four months, and (b) that the trustee may assert rights, respecting transactions *prior* to the four months, which all the creditors, united as co-plaintiffs, could not assert.

A paper, in November, 1911, *West Virginia Bar,* points out; (a) That congress intended to secure equality commencing four months before bankruptcy, but not disturbing rights which had vested, under state law, prior to the four months. (Hurst conveyed to Tearney six years before bankruptcy.) (b) That 64b says: "The order of payment shall be * * * to persons who, *by state law,* are entitled to priority.". (The act of 1867 did not contain the words, "by state law.") (c) That congress did not intend that, when property (conveyed prior to the four months) was recovered in the right of one man, then the bankruptcy court should give it to a different man. Said paper cites the cases. The undersigned will mail a re-print of that paper on request.

But Tearney says: The referee (inadvertently) ordered suit "for the benefit of *all* creditors who had proved debts," and that he had proved his debt.

Briefly, a man cannot give to his assignee a right which belonged to a creditor. The Virginia, ca. sa. law gave to the sheriff, when assignee of an insolvent, "any right which a creditor could assert." The sheriff did not assert for B's benefit, a right which belonged to A. Hutchinson *v.* First Nat. Bank, 133 Ind. 271, 36 Am. St. 544, gives clear-cut views. The paper in the November *Bar,* points out that the Bankrupt Act is careless. Suffice it, that the more recent opinions, if well-considered, say (in substance): Congress *nullified* a fraudulent transfer *if* within the four months, and, it being a "nullity," title never left the bankrupt. Hence, as to four months transfers, it was correct to say, "the trustee is vested with the bankrupt's

title to property transferred in fraud of creditors. But, as to transfers, prior to the four months, the trustee is vested with the *rights* of creditors." The question then narrows to whether an inadvertence by the referee created rights, or destroyed rights. The prayer of the bill should have been, to declare the deed void as to the rights of plaintiffs. The prayer was, to set aside as to such debts as had been proved. The decree does not follow the prayer, it "sets aside as to the *rights* of the trustees." Hutchinson *v.* First Nat. Bank, supra, points out that, in such cases, the court does not identify creditors.

Many opinions (Trimble *v.* Woodhead, 102 U. S. 647, 26 L. Ed. 290, for example) say: "Congress intended to secure equality." It is most useful to notice that in *every* case (except In re Hurst, 188 Fed. 707) the court was speaking to a transaction within the four months. The opinion is based on the proposition that congress intended to establish the same equality, respecting transfers prior to the four months, that it did establish respecting transfers within the four months. Verbum sat. 1 Rem. Bankruptcy, p. 666, last paragraph.

If the conveyance was *not* avoided as to Tearney then all creditors, except Tearney, prorated in the proceeds of sale.

Suppose the conveyance *was* avoided as to Tearney's $18,000 borrowed money debt, then comes the question whether he can prorate with creditors whom he misled?

The decisions, distributing the proceeds of sale in fraudulent conveyance cases, divide into six well-defined groups.

Group one. Where the debt was connected with the fraud, as in Garland *v.* Rives, 4 Rand. 282, 15 Am. Dec. 756; Milwaukee, etc., R. Co. *v.* Soutter, 13 Wall. 517, 20 L. Ed. 543. (This is the largest group, but is irrelevant because Tearney's debt was not mixed up with his purchase.)

Group two. Where the creditor had assented, as in Olliver *v.* King, 8 D. M. & G.; s. c., 55 Eng. Law & Eq. —; Pell *v.* Tredwell, 5 Wend. 661, etc.

Group three. Where the creditor "schemed" for advantage over other creditors, as where he "padded" his debt. (Deci-

sions in this group are relevant only as illustrating the equity principles controlling distribution.)

Group four. Where a creditor claimed priority because of diligence. (Irrelevant.)

Group five. Where the deed was void as to one class only:

(a) As a gift would be void (in Virginia) as to one class only. [4]

(b) As where certain creditors refused to attack the conveyance.

(c) As where the deed, being valid between parties, was not avoided as to the grantee-creditor.

(Observe. Decisions under sub-groups (a) and (b) are irrelevant when the only question is, whether a creditor should be postponed if he has held out his debtor as the owner whereby others were misled to give credit to an insolvent.)

Group six. Where the *conduct* of a creditor has destroyed his right to equality. Has "disfranchised him of rights," as White *v.* Graves expresses it, and as illustrated by:

Draper *v.* Borlace (1699), 2 Vern. Borlace owned two manors. Naylor loaned him $2,000 on a first mortgage on Black acre, and Hill loaned him $1,000 on a second mortgage on this same manor, but Hill also got from Borlace a writing, called "a statute," which was a first lien on White acre. Later, Borlace asked Draper for a loan on White acre and Draper consulted Hill who, forgetting about his "statute," advised the loan. Then Borlace went broke, and both manors being sold, the chancellor postponed Hill to Draper because he had not *volunteered* to tell about his statute. There was no suggestion of bad faith, but Hill lost the priority he would have had at law. (Considerable research seems to show that this ancient case has never been questioned, but always followed if an opinion was well considered.)

There is a distinct, unbroken and controlling line of decisions, running back to 13 Eliz. grounded on the proposition, or

4. In some jurisdictions (and in Federal courts, unless dealing with state law), a "gift," if void as to pre-existing creditors, is void as to all creditors. Hence Kehr *v.* Smith, 20 Wall. 31, 22 L. Ed. 313. But this is not West Virginia law. See cases like O'Brien *v.* Greer, 36 W. Va. 277, 15 S. E. 74.

doctrine, that public policy[5] requires equity courts to discourage fraud by shutting out litigants whose conduct is such conduct as would be followed by the average man when actuated by corrupt motive. Expressed briefly, the doctrine is, that (quoad fraud), 'tis better that one innocent man should suffer than that ninety-nine guilty should escape.

The undisputed fact is, that Tearney permitted Hurst to hold himself out as owner and thereby incur debts while insolvent.

There are many cases like Hildeburn *v.* Brown, 17 B. Mon. — (quoted in Blennerhassett *v.* Sherman, 105 U. S. 100, 26 L. Ed. 1080), which says: "The effect of this arrangement" (to hold up the deed) "was to mislead, * * * was opposed to public policy." Blennerhassett quotes Neslin *v.* Wells, 104 U. S. 428, 26 L. Ed. 802, saying: "It being the *custom,* in that locality, to record, failure to record was negligence and the loss must fall on him whose negligence caused it." Citing Tarback *v.* Marbury (1675), 2 Vern.

Tearney makes no reply except to say: (a) That it was his "habit" not to record deeds; (b) that there is no proof that he had notice that Hurst was holding himself out as owner, and (c) that Hurst, being a son-in-law, was permitted to continue farming and remain in the town-house "as an indulgence" during all the six years.

("Habit" is not a defense to "negligence." The state court adjudicated that Tearney knew Hurst was insolvent. Being father-in-law may explain why no rent was exacted, but not why such secrecy was maintained that nobody had reason to suspect any change of ownership. Observe, laymen think that "postponing" depends on the motive which actuated the holding out, and Tearney's executors state that, after his death, they concealed the deeds, at Hurst's request, to prevent a crisis in his affairs. This is exactly what Blennerhassett *v.* Sherman says is a common-law fraud.)

5. See Words and Phrases as to the meaning of Public Policy. There is an unbroken line of cases, older than 13 Eliz. (like Horn *v* Star Foundry Co., 23 W. Va. 522), grounded on the proposition that equity courts should so administer the law as to discourage conduct "calculated" to hinder creditors. There is another line of cases (like Hulings *v.* Hulings Lumber Co., 38 W. Va. 351, 18 S. E. 620), based on the doctrine of forfeiting rights if the conduct was the conduct of a man actuated by wrong motive.

Observe, postponing is not affected by the fact that Tearney was a grantee-creditor. Suppose a stranger had asked the bank whether Hurst was good for a loan and the bank (the bank having an unrecorded deed) answered that he owned the farm, then could the bank prorate as against this stranger?

The doctrine is, that a loss must fall on him whose negligence caused it. 'Tis worse than irrelevant to talk about "punishment."[6] The question is about departing from an unbroken line of decisions running back 300 years.

There are two lines of cases which deal with doctrines altogether different, and they must be kept separate. The first line deals with questions arising when a conveyance is attacked because void under 13 Eliz. (like Garland *v.* Rives), or because a common law fraud (like Blennerhassett). The second line deals with the propositions: (a) That a grantee-creditor cannot prorate if he misled neighbors, and (b) that a loss should fall on him whose negligence caused it.

Observe, the fact, that a grantee permitted his grantor to retain possession is some evidence of the grantor's intent, and also some evidence that the grantee had notice. But the intent which existed, *at the making* of the conveyance, is wholly irrelevant to the doctrine that equity will postpone a creditor whose conduct enabled an insolvent to borrow.

It should be remembered that, when this case was before Judge McWhorter (Moore *v.* Tearney, 62 W. Va. 725, 7 S. E. 263) he was sitting in a tribunal which had no jurisdiction except to inquire whether Hurst intended to hinder. His quotation from 2 Pomeroy, § 803 ("When one of two must suffer"), was irrelevant to any matter before him.

Confusion exists because hasty opinions do not distinguish the *reasoning,* why a grantee-creditor should be postponed, from the *reasoning* why permitting the grantor of land to remain in possession, does not prove the intent to hinder. Observe, McWhorter explains that our recording acts are irrelevant.

Again, some hasty opinions seem grounded on the fallacy

6. The word "punishment" has been used only where creditors contended that the grantee should account for *more* than he had received. See Hamilton Nat. Bank *v.* Halstead. 134 N. Y. 520, 30 Am. St. Rep. 693; Knowlton's Big, 475.

that, permitting an insolvent grantor to hold himself out as owner, forfeits no right unless actuated by corrupt motive.

Postponing a creditor, who gave an insolvent fictitious credit, should be distinguished from estoppel. Postponing is sometimes put on the ground that "it would be inequitable to prorate," and sometimes on the ground of public policy. Personal intent has nothing to do with it. A creditor was postponed who carelessly forgot to remove the partnership sign after he had quit the firm. See Knowlton's Bigelow, title "holding out" in his index, and also in 2 Bigelow.

True, there is great lack of clearness of thought in many opinions but it seems safe to say that all well-considered decisions accord with Draper *v.* Borlace.

Quoad distributing the proceeds of sale, it is irrelevant to inquire whether judge McWhorter considered the deed void as a common-law fraud, or void under 13 Eliz. He says: Hurst was fraudulently attempting to place his property beyond the reach of creditors and Tearney knew of his insolvency. Moore *v.* Tearney, 57 S. E. 263, 62 W. Va. 72, 76. Hence, it was fraud-in-fact. True, Tearney paid value, but there is no suggestion that he paid without notice. And this probably explains why Tearney's counsel have made it an "agreed act" that the deed was adjudged void for fraud-in-fact.

The bankruptcy court comes to distribute the proceeds of sale, and comes controlled by the facts "adjudicated" by McWhorter; to-wit:

Fact one. Tearney was a fraud-in-fact grantee.

Fact two. Tearney held Hurst out as owner.

Questions. (1) Can he prorate with misled creditors? (2) Do the facts "adjudicated," in 62 W. Va. prove that Tearney permitted Hurst to hold himself out as owner? (3) Shall a loss fall on him whose negligence caused it?

Judge McWhorter said: There is no question that Hurst was fraudulently attempting to place his property beyond the reach of creditors and that Tearney knew of his insolvency. * * * Tearney put the deed in his safe and did not mention it except to his daughter: none of his other children heard of it till six years later. "By concealing the transaction * * * Hurst was

able to continue business by holding himself out as owner." Referring to Hurst having offered to give a first lien, he says: "Tearney, by his conduct, must be held to have ratified said statements and acts of Hurst as being the real owner. * * * Hurst remained in possession without any indication of any change in ownership."

(Observe, when the case was before McWhorter (the then) counsel supposed that fraud-in-fact was established by proving ex post facto facts. It is irrelevant to ask *why* such facts were proved; it is sufficient, quoad the consequences of misleading neighbors to credit an insolvent, that such facts did exist.)

HARDSHIP.

The truth is that, unless one reflects, it does look like a hardship that Tearney should lose both the $14,000 paid for farm and house and also his $18,000 debt. But the *law* thinks only about the $35,000 of misled creditors. The *law* sees nothing except that, if the deed had not been attacked till the statute barred debts, then Tearney would have stood as a preferred creditor for his suretyship debt and would have possessed *all* Hurst had except the $5,000 of personalty.

Again, there was no failure of consideration. Tearney got what he bought. He bought subject to the risk of attack. Suppose an earthquake had destroyed the property. He lost the $14,000 because Hurst intended to hinder. He is postponed, as to his debt, because of conduct *subsequent* to the conveyance. His loss, by being postponed, has no connection with his loss caused by Hurst's intent to hinder.

In Garland *v.* Rives, Garland was exonerated, but lost his debt. Soutter meant no wrong in Milwaukee *v.* Soutter, but lost $450,000. There is a case in Vernon, Atkyns or Raymond saying, in substance: "This court has nothing to do with hardships. It is here to declare the law as settled by precedent." Hitchcox *v.* Sedgewick (1690), 2 Vern. says: "Though he had an honest debt, he had lost it by playing a trick to come at it."

As to the power of the referee to postpone, see 2 Rem. §§ 2219 and 2220; In re Headley, 2 A. B. R. quoted in 2 Rem. 1363.

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(To be continued.)